EXHIBIT B
PART 2

change (paragraphs 19 to 26) but that a few specific changes in accounting principles should be reported by restating the financial statements of prior periods (paragraphs 27 to 30 and 34 to 35).

19. For all changes in accounting principle except those described in paragraphs 27 to 30 and 34 to 35, the Board therefore concludes that:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.

b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change (paragraph 20).

c. The effect of adopting the new accounting principle on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change should be disclosed.

d. Income before extraordinary items and net income computed on a pro forma basis [6] should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected (paragraph 21).

Thus, income before extraordinary items and net income (exclusive of the cumulative adjustment) for the period of the change should be reported on the basis of the newly adopted accounting principle. The conclusions in this paragraph are modified for various special situations which are described in paragraphs 23 to 30.

20. *Cumulative effect of a change in accounting principle.* The amount shown in the income statement for the cumulative effect of changing to a new accounting principle is the difference between (a) the amount of retained earnings at the beginning of the period of a change and (b) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods which would have been affected and by recognizing only the direct effects of the change and related income tax effect. [7] The amount of the cumulative effect should be shown in the income statement between the captions "extraordinary items" and "net income." The cumulative effect is not an extraordinary item but should be reported in a manner similar to an extraordinary item. Presentation of per-share amounts for the cumulative effect of an accounting change shall be made either on the face of the income statement or in the related notes.

21. *Pro forma effects of retroactive application.* Pro forma effects of retroactive application (paragraph 19-d including footnote 6) should be shown on the face of the income statement for income before extraordinary items and net income. The earnings per share amounts (basic and diluted, as appropriate under FASB Statement No. 128, *Earnings per Share*) for income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statement. If space does not permit, such per share amounts may be disclosed prominently in a separate schedule or in tabular form in the notes to the financial statements with appropriate cross reference; when this is done the actual per share amounts should be repeated

for comparative purposes. Pro forma amounts should be shown in both current and future reports for all periods presented which are prior to the change and which would have been affected. Appendix A illustrates the manner of reporting a change in accounting principle. If an income statement is presented for the current period only, the actual and the pro forma amounts (and related per share data) for the immediately preceding period should be disclosed.

22. The principal steps in computing and reporting the cumulative effect and the pro forma amounts of a change in accounting principle may be illustrated by a change in depreciation method for previously recorded assets as follows:

a. The class or classes of depreciable assets to which the change applies should be identified. (A "class of assets" relates to general physical characteristics.)

b. The amount of accumulated depreciation on recorded assets at the beginning of the period of the change should be recomputed on the basis of applying retroactively the new depreciation method. Accumulated depreciation should be adjusted for the difference between the recomputed amount and the recorded amount. Deferred taxes should be adjusted for the related income tax effects.

c. The cumulative effect on the amount of retained earnings at the beginning of the period of the change resulting from the adjustments referred to in (b) above should be shown in the income statement of the period of the change.

d. The pro forma amounts should give effect to the pro forma provisions for depreciation of each prior period presented and to the pro forma adjustments of nondiscretionary items, [8] computed on the assumption of retroactive application of the newly adopted method to all prior periods and adjusted for the related income tax effects.

23. *Change in method of amortization and related disclosure.* Accounting for the costs of long-lived assets requires adopting a systematic pattern of charging those costs to expense. These patterns are referred to as depreciation, depletion, or amortization methods (all of which are referred to in this Opinion as methods of amortization). Various patterns of charging costs to expenses are acceptable for depreciable assets; fewer patterns are acceptable for other long-lived assets.

24. Various factors are considered in selecting an amortization method for identifiable assets, and those factors may change, even for similar assets. For example, a company may adopt a new method of amortization for newly acquired, identifiable, long-lived assets and use that method for all additional new assets of the same class but continue to use the previous method for existing balances of previously recorded assets of that class. For that type of change in accounting principle, there is no adjustment of the type outlined in paragraphs 19-22, but a description of the nature of the change in method and its effect on income before extraordinary items and net income of the period of the change, together with the related per share amounts, should be disclosed. If the new method of amortization is however applied to previously recorded assets of that class, the change in accounting principle requires an adjustment for the cumulative effect of the change and the provisions of paragraphs 15 to 22 should be applied.

25. *Pro forma amounts not determinable.* In rare situations the pro forma amounts described in paragraph 21 cannot be computed or reasonably estimated for individual prior periods, although the cumulative effect on retained earnings at the beginning of the period of change can be determined. The cumulative effect should then be reported in the income statement of the period of change in the manner described in paragraph 20. The reason for not showing the pro forma amounts by periods should be explained because disclosing those amounts is otherwise required and is expected by users of financial statements.

26. *Cumulative effect not determinable.* Computing the effect on retained earnings at the beginning of the period in which a change in accounting principle is made may sometimes be impossible. In those rare situations, disclosure will be limited to showing the effect of the change on the results of operations of the period of change (including per share data) and to explaining the reason for omitting accounting for the cumulative effect and disclosure of pro forma amounts for prior years. The principal example of this type of accounting change is a change in inventory pricing method from FIFO to LIFO for which the difficulties in computing the effects of that change are described in paragraph 14-d.

27. *Special changes in accounting principle reported by applying retroactively the new method in restatements of prior periods.* Certain changes in accounting principle are such that the advantages of retroactive treatment in prior period reports outweigh the disadvantages. Accordingly, for those few changes, the Board concludes that the financial statements of all prior periods presented should be restated. The changes that should be accorded this treatment are: (a) a change from the LIFO method of inventory pricing to another method, (b) a change in the method of accounting for long-term construction-type contracts, (c) a change to or from the "full cost" method of accounting which is used in the extractive industries, and (d) a change from retirement-replacement-betterment accounting to depreciation accounting.

28. The nature of and justification for a change in accounting principle described in paragraph 27 should be disclosed in the financial statements for the period the change was adopted. In addition, the effect of the change on income before extraordinary items, net income, and the related per share amounts should be disclosed for all periods presented. This disclosure may be on the face of the income statement or in the notes. Appendix B illustrates the manner of reporting a change in accounting principle retroactively by restating the statements of those prior periods affected. Financial statements of subsequent periods need not repeat the disclosures.

29. *Special exemption for an initial public distribution.* The Board concludes that in one specific situation the application of the foregoing provisions of this Opinion may result in financial statement presentations of results of operations that are not of maximum usefulness to intended users. For example, a company owned by a few individuals may decide to change from one acceptable accounting principle to another acceptable principle in connection with a forthcoming public offering of shares of its equity securities. The potential investors may be better served by statements of income for a period of years reflecting the use of the newly adopted accounting principles because they will be the same as those expected to be used in future periods. In recognition of this situation, the Board concludes that financial statements for all prior periods presented may be restated retroactively when a company first issues its financial statements for any one of the following purposes: (a) obtaining additional equity capital from

investors, (b) effecting a business combination, or (c) registering securities. This exemption is available only once for changes made at the time a company's financial statements are first used for any of those purposes and is not available to companies whose securities currently are widely held.

30. The company should disclose in financial statements issued under the circumstances described in paragraph 29 the nature of the change in accounting principle and the justification for it (paragraph 17).

Reporting a Change in Accounting Estimate

31. The Board concludes that the effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

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[9][This footnote has been deleted. See Status page.]

32. A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate (paragraph 11). Although that type of accounting change is somewhat similar to a change in method of amortization (paragraphs 23 and 24), the accounting effect of a change in a method of amortization can be separated from the effect of a change in the estimate of periods of benefit or service and residual values of assets. A change in method of amortization for previously recorded assets therefore should be treated as a change in accounting principle, whereas a change in the estimated period of benefit or residual value should be treated as a change in accounting estimate.

33. *Disclosure.* The effect on income before extraordinary items, net income and related per share amounts of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is recommended if the effect of a change in the estimate is material.

Reporting a Change in the Entity

34. The Board concludes that accounting changes which result in financial statements that are in effect the statements of a different reporting entity (paragraph 12) should be reported by

restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods. [9a]

35. *Disclosure*. The financial statements of the period of a change in the reporting entity should describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income, and related per share amounts should be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures. (Paragraphs 51?58 of FASB Statement No. 141, *Business Combinations*, describe the manner of reporting and the disclosures required for a change in reporting entity that occurs because of a business combination.)

Reporting a Correction of an Error in Previously Issued Financial Statements

36. The Board concludes that correction of an error in the financial statements of a prior period discovered subsequent to their issuance (paragraph 13) should be reported as a prior period adjustment. (Paragraph 18 of APB Opinion No. 9 covers the manner of reporting prior period adjustments.)

37. *Disclosure*. The nature of an error in previously issued financial statements and the effect of its correction on income before extraordinary items, net income, and the related per share amounts should be disclosed in the period in which the error was discovered and corrected. Financial statements of subsequent periods need not repeat the disclosures.

Materiality

38. The Board concludes that a number of factors are relevant to the materiality of (a) accounting changes contemplated in this Opinion and (b) corrections of errors, in determining both the accounting treatment of these items and the necessity for disclosure. Materiality should be considered in relation to both the effects of each change separately and the combined effect of all changes. If a change or correction has a material effect on income before extraordinary items or on net income of the current period before the effect of the change, the treatments and disclosures described in this Opinion should be followed. Furthermore, if a change or correction has a material effect on the trend of earnings, the same treatments and disclosures are required. A change which does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods should be disclosed whenever the financial statements of the period of change are presented.

Historical Summaries of Financial Information

39. Summaries of financial information for a number of periods are commonly included in financial reports. The summaries often show condensed income statements, including related earnings per share amounts, for five years or more. In many annual reports to stockholders, the financial highlights present similar information in capsule form. The Board concludes that all such information should be prepared in the same manner (including the presentation of pro forma amounts) as that prescribed in this Opinion for primary financial statements (paragraphs 15 to

38) because the summaries include financial data based on the primary financial statements. In a summary of financial information that includes an accounting period in which a change in accounting principle was made, the amount of the cumulative effect of the change that was included in net income of the period of the change should be shown separately along with the net income and related per share amounts of that period and should not be disclosed only by a note or parenthetical notation.

EFFECTIVE DATE

40 The provisions of this Opinion are effective for fiscal years beginning after July 31, 1971. However, the Board encourages application of the provisions of this Opinion in reporting any accounting changes included in fiscal years beginning before August 1, 1971 but not yet reported in financial statements issued for the year of the change.

The Opinion entitled "Accounting Changes" was adopted by the assenting votes of twelve members of the Board. Messrs. Catlett, Halvorson, Harrington, Kessler, Luper, and Watt dissented.

Messrs. Catlett, Kessler and Luper dissent to this Opinion because they believe that when a change in accounting principles is made the financial statements for prior periods should be restated on the same basis as those for the current period. The Board has reached a similar conclusion in most previous Opinions, since such Opinions have encouraged or required retroactive treatment for recommended changes in accounting principles. They also believe that the cumulative adjustments applicable to prior periods arising from changes in accounting principles have no bearing upon the current results of operations and should not be included in the determination of net income for the current period. This Opinion recognizes that consistent use of accounting principles "enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data" and that changes in accounting principles should not be made unless the principle adopted is "preferable." Yet, when such changes are made, this Opinion places severe constraints on restatement and thus not only precludes "preferable" accounting for prior periods in many areas but also impairs the comparability of the financial statements.

Mr. Harrington and Messrs. Catlett, Kessler and Luper dissent to this Opinion because in their view the great divergence between the selective requirements for restatement in paragraphs 27, 29 and 34 and the general requirements for cumulative adjustments in paragraphs 19 and 24 is not based on any supportable rationale; and such general requirements will be confusing and will contribute far more to the dilution of public confidence in financial reporting than would the restatement of prior periods for all changes in accounting principles. Furthermore, Messrs. Catlett, Harrington and Luper are particularly concerned with the continuing tendency of the Board to attempt to eliminate alleged "abuses" by means of arbitrary rules and to use accounting requirements as a disciplinary tool rather than to establish standards for the most meaningful financial reports for investors and other users of financial statements. They believe that the cumbersome requirements of this Opinion will discourage improvements in accounting in numerous areas on which the Board will not issue Opinions for many years.

Mr. Halvorson dissents because he believes that all income and expense should be included in the income statement once and neither more nor less than once, and that this can really be achieved only if newly-adopted principles are applied prospectively. The cumulative adjustment required by the Opinion for most accounting changes ignores this cardinal tenet of reporting by effectively obscuring the result if the one-time inclusion is accommodated in the cumulative adjustment and completely negating the desired result when the cumulative adjustment requires duplication in the future of items already accounted for and reported in earlier periods. He believes that restatement ("actual" or pro forma) of information previously published in good faith will endanger the credibility of financial reporting and that availability of the cumulative-adjustment device will minimize the disciplinary effect that accounting has on the issuers of financial statements. It should be sufficient to report the dollar effect of a change (the "inconsistency") in the year of change, and in a multi-period statement including the year of change to disclose the principle applied in each of the several included periods. It is the further view of Mr. Halvorson that the required pro forma presentation for past years cannot properly report the operating results for such years as they would have been if the newly-adopted principle had then been used, because reported operating results themselves have a compelling influence on non-accounting operating decisions in such areas as pricing and methods of financing, and the effect of such decisions cannot be arithmetically reconstructed to reflect the effect of what might have been.

Mr. Watt dissents to this Opinion because its conclusions are not in accord with his view that the best presentation is one that does not require excessive interpretation by the financial statement user. He believes that, with respect to accounting changes, it is more important for statements presented in comparative form to be comparable in detail than for historical continuity to be retained there; such continuity is important and changes to amounts previously reported can be adequately reconciled in the notes to financial statements. Thus, the presumption should be that, with respect to accounting changes, retroactive restatement is most desirable wherever statements are presented in comparative form. The exception to this would be where the change relates to items whose carrying amount involves a substantial valuation judgment. Mr. Watt is in agreement with the conclusion in the Opinion that depreciation lives of assets are an element of the estimation process and changes therein should be applied prospectively. He believes, however, that depreciation method changes, although conceptually accounting changes, are inextricably tied to subjective judgment of the periods of exhaustion of the useful lives of assets and therefore the selection of a method is usually the result of a composite decision involving both methods and estimated useful lives. Thus, it is his view that all changes in depreciation methods should be reflected prospectively. Similarly, accounting changes relating to the amortization of depletable costs, goodwill, preoperating and research and development cost, etc. should be reflected prospectively. This view as it relates to pension accruals is also consistent with that expressed in paragraph 47 of APB Opinion No. 8, *Accounting for the Cost of Pension Plans*, that a change in accounting method should be applied prospectively.

APB 20 NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

Accounting Principles Board (1971)

Appendix A: An Illustration of Reporting a Change in Accounting Principles (Pursuant to paragraphs 19 to 22)

41. ABC Company decides in 1971 to adopt the straight line method of depreciation for plant equipment. The straight line method will be used for new acquisitions as well as for previously acquired plant equipment for which depreciation had been provided on an accelerated method.

42. This illustration assumes that the direct effects are limited to the effect on depreciation and related income tax provisions and that the direct effect on inventories is not material. The pro forma amounts have been adjusted for the hypothetical effects of the change in the provisions for incentive compensation. The per share amounts are computed assuming that 1,000,000 shares of common stock are issued and outstanding, that 100,000 additional shares would be issued if all outstanding bonds are converted, and that the annual interest expense, less taxes, for the convertible bonds is $25,000. Other data assumed for this illustration are—

Year	*Excess of Accelerated Depreciation Over Straight Line Depreciation*	*Effects of Change Direct, Less Tax Effect*	*Pro forma (Note A)*
Prior to 1967	$ 20,000	$ 10,000	$ 9,000
1967	80,000	40,000	36,000
1968	70,000	35,000	31,500
1969	50,000	25,000	22,500
1970	30,000	15,000	13,500
Total at beginning of 1971	$250,000	$125,000	$112,500

43. The manner of reporting the change in two-year comparative statements is—

	1971	*1970*
Income before extraordinary item and cumulative effect of a change in accounting principle	$1,200,000	$1,100,000
Extraordinary item (description)	(35,000)	100,000
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method (Note A)	125,000	
Net Income	$1,290,000	$1,200,000
Per share amounts—		
Earnings per common share—assuming no dilution:		
Income before extraordinary item and cumulative effect of a change in accounting principle	$ 1.20	$1.10
Extraordinary item	(0.04)	0.10
Cumulative effect on prior years (to December 31,1970) of changing to a different depreciation method	0.13	
Net income	$ 1.29	$1.20
Earnings per common share—assuming dilution:		
Income before extraordinary item and cumulative effect of a change in accounting principle	$ 1.11	$1.02
Extraordinary item	(0.03)	0.09

Cumulative effect on prior years (to December 31,1970) of changing to a different depreciation method	0.11	
Net income	$ 1.19	$1.11
Pro forma amounts assuming the new depreciation method is applied retroactively—		
Income before extraordinary item	$1,200,000	$1,113,500
Earnings per common share—assuming no dilution	$1.20	$1.11
Earnings per common share—assuming dilution	$1.11	$1.04
Net income	$1,165,000	$1,213,500
Earnings per common share—assuming no dilution	$1.17	$1.21
Earnings per common share—assuming dilution	$1.08	$1.13
(See accompanying note to the financial statements)		

NOTE A:
Change in Depreciation Method for Plant Equipment

Depreciation of plant equipment has been computed by the straight line method in 1971. Depreciation of plant equipment in prior years, beginning in 1954, was computed by the sum of the years digits method. The new method of depreciation was adopted to recognize. . . (state justification for change of depreciation method). . . and has been applied retroactively to equipment acquisitions of prior years. The effect of the change in 1971 was to increase income before extraordinary item by approximately $10,000 (or one cent per share). The adjustment of $125,000 (after reduction for income taxes of $125,000) to apply retroactively the new method is included in income of 1971. The pro forma amounts shown on the income statement have been adjusted for the effect of retroactive application on depreciation, the change in provisions for incentive compensation which would have been made had the new method been in effect, and related income taxes.

.44. The manner of reporting the change in five-year comparative statement is—

	1971	*1970*	*1969*	*1968*	*1967*
Income before extraordinary item and cumulative effect of a change in accounting principle	$1,200,000	$1,100,000	$1,300,000	$1,000,000	$800,000
Extraordinary item	(35,000)	100,000		40,000	
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method (Note A)	125,000				
Net income	$1,290,000	$1,200,000	$1,300,000	$1,040,000	$800,000
Earnings per common share—assuming no dilution:					
Income before extraordinary item and cumulative effect of change in accounting principle	$1.20	$1.10	$1.30	$1.00	$0.80
Extraordinary item	(0.04)	0.10		0.04	
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.13				
Net income	$1.29	$1.20	$1.30	$1.04	$0.80
Earnings per common share—assuming dilution:					
Income before extraordinary item and cumulative effect of change in accounting principle	$1.11	$1.02	$1.20	$0.93	$0.75
Extraordinary item	(0.03)	0.09	0.04		
Cumulative effect on prior years (to December 31, 1970) of changing to a different depreciation method	0.11				
Net income	$1.19	$1.11	$1.20	$0.97	$0.75
Pro forma amounts assuming the new depreciation method is applied retroactively:					
Income before extraordinary item	$1,200,000	$1,113,500	$1,322,500	$1,031,500	$836,000
Earnings per common share—assuming no dilution	$1.20	$1.11	$1.32	$1.03	$0.84
Earnings per common share—assuming dilution	$1.11	$1.04	$1.23	$0.96	$0.78
Net income	$1,165,000	$1,213,500	$1,322,500	$1,071,500	$836,000
Earnings per common share—assuming no dilution	$1.17	$1.21	$1.32	$1.07	$0.84
Earnings per common share—assuming dilution	$1.08	$1.13	$1.23	$1.00	$0.78

A note similar to Note A of this Appendix should accompany the five-year comparative income statement.

Appendix B: An Illustration of Reporting a Special Change in Accounting Principle by Restating Prior Period Financial Statements (Pursuant to paragraphs 27 and 28)

45. XYZ Company decides in 1971 to adopt the percentage of completion method in accounting for all of its long-term construction contracts. The company has used in prior years the completed contract method and had maintained records which are adequate to apply retroactively the percentage of completion method. The change in accounting principle is to be reported in the manner described in paragraphs 27 and 28 of this Opinion.

46. The direct effect of the change in accounting principle and other data assumed for this illustration are—

	Pre-tax Income Reported by		*Difference in Income*	
Year	*Percentage of Completion Method*	Completed Contract *Method*	*Direct*	Less Tax *Effect*
Prior to 1967	$1,800,000	$1,300,000	$ 500,000	$ 250,000
1967	900,000	800,000	100,000	50,000
1968	700,000	1,000,000	(300,000)	(150,000)
1969	800,000	600,000	200,000	100,000
1970	1,000,000	1,100,000	(100,000)	(50,000)
Total at beginning of 1971	5,200,000	4,800,000	400,000	200,000
1971	1,100,000	900,000	200,000	100,000
Total	$6,300,000	$5,700,000	$ 600,000	$ 300,000

The per share amounts are computed assuming that 1,000,000 shares of common stock are issued and outstanding, that 100,000 additional shares would be issued if all outstanding bonds are converted, and that the annual interest expense, less taxes, for the convertible bonds is $25,000.

47. The manner of reporting the change in two-year comparative statements is—

Income Statement:	1971	*1970 as adjusted (Note A)*
Income before extraordinary item	$ 550,000	$ 500,000
Extraordinary item (description)		(80,000)
Net Income	$ 550,000	$ 420,000
Per share amounts:		
Earnings per common share—assuming no dilution:		
Income before extraordinary item	$0.55	$0.50
Extraordinary item		(.08)
Net income	$0.55	$0.42
Earnings per common share—assuming dilution:		
Income before extraordinary item	$0.52	$0.47
Extraordinary item		(.07)
Net income	$0.52	$0.40
Statement of Retained Earnings	*1971*	*1970 as adjusted (Note A)*
Balance at beginning of year, as previously reported	$17,800,000	$17,330,000

Add adjustment for the cumulative effect on prior years of applying retroactively the new method of accounting for long-term contracts (Note A)	200,000	250,000
Balance at beginning of year, as adjusted	$18,000,000	$17,580,000
Net income	550,000	420,000
Balance at end of year	$18,550,000	$18,000,000

(See accompanying note to the financial statements)

NOTE A:
Change in Method of Accounting for Long-Term Contracts

The company has accounted for revenue and costs for long-term construction contracts by the percentage of completion method in 1971, whereas in all prior years revenue and costs were determined by the completed contract method. The new method of accounting for long-term contracts was adopted to recognize . . . (state justification for change in accounting principle) . . . and financial statements of prior years have been restated to apply the new method retroactively. For income tax purposes, the completed contract method has been continued. The effect of the accounting change on income of 1971 and on income as previously reported for 1970 is—

	Increase (Decrease)	
Effect on—	*1971*	*1970*
Income before extraordinary item and net income	$100,000	$(50,000)
Earnings per common share—assuming no dilution	$0.10	($0.05)
Earnings per common share—assuming dilution	$0.09	($0.05)

The balances of retained earnings for 1970 and 1971 have been adjusted for the effect (net of income taxes) of applying retroactively the new method accounting.

48. A note to a five-year summary of financial statements should disclose the effect of the change on net income and related per share amounts for the periods affected in the following manner:

NOTE A:
Change in Method of Accounting for Long-Term Contracts

The company has accounted for revenue and costs for long-term construction contracts by the percentage of completion method in 1971, whereas in all prior years revenue and costs were determined by the completed contract method. The new method of accounting for long-term contracts was adopted to recognize . . . (state justification for change in accounting principle) . . . and financial statements of prior years have been restated to apply the new method retroactively. For income tax purposes, the completed contract method has been continued. The effect of the accounting change on net income as previously reported for 1970 and prior years is—

	1970	*1969*	*1968*	*1967*
Net income as previously reported	$470,000	$300,000	$500,000	$400,000
Adjustment for effect of a change in accounting principle that is applied retroactively	(50,000)	100,000	(150,000)	50,000
Net income as adjusted	$420,000	$400,000	$350,000	$450,000
Per share amounts:				
Earnings per common share—assuming no dilution:				
Net income as previously reported	$0.47	$0.30	$0.50	$0.40
Adjustment for effect of a change in accounting principle that is applied retroactively	(0.05)	0.10	(0.15)	0.05
Net income as adjusted	$0.42	$0.40	$0.35	$0.45
Earnings per common share—assuming dilution:				
Net income as previously reported	$0.45	$0.30	$0.47	$0.38
Adjustment for effect of a change in accounting principle that is applied retroactively	(0.05)	0.09	(0.13)	0.05
Net income as adjusted	$0.40	$0.39	$0.34	$0.43

1 (Popup-Popup)
APB20, Footnote 1—This Opinion amends APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, to the extent that it relates to reporting accounting changes.

2 (Popup-Popup)
APB20, Footnote 3—A change to the straight line method at a specific point in the service life of an asset may be planned at the time the accelerated depreciation method is adopted to fully depreciate the cost over the estimated life of the asset. Consistent application of such a policy does not constitute a change in accounting principle for purposes of applying this Opinion. (tParagraph 5-d of APB Opinion No. 12 covers disclosure of methods of depreciation.)

3 (Popup-Popup)
APB20, Footnote 4—Section 561 of Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, discusses other aspects of errors in previously issued financial statements.

4 (Popup-Popup)
APB20, Footnote 6—The pro forma amounts include both (a) the direct effects of a change and (b) nondiscretionary adjustments in items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods: related income tax effects should be recognized for both (a) and (b). Direct effects are limited to those adjustments that would have been recorded to restate the financial statements of prior periods to apply retroactively the change. The nondiscretionary adjustments described in (b) should not therefore be recognized in computing the adjustment for the cumulative effect of the change described in paragraph 20 unless nondiscretionary adjustments of the prior periods are actually recorded.

5 (Popup-Popup)
APB20, Footnote 7—See footnote 6.

6 (Popup-Popup)
APB20, Footnote 8--See footnote 6.

7 (Popup-Popup)
APB20, Footnote 9a—The amount of interest cost capitalized through application of FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method,* shall not be changed when restating financial statements of prior periods.

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Source:
AICPA Literature/Technical Practice Aids/AICPA Technical Practice Aids /Statements of Position — Accounting [ACC]/ACC Section 10,000 — Statements of Position — Accounting/SOP 94-6: Disclosure of Certain Significant Risks and Uncertainties (ACC Section 10,640)

ACC Section 10,640

Statement of Position 94-6 Disclosure of Certain Significant Risks and Uncertainties

December 30, 1994

NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Introduction

.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the *Report of the Task Force on Risks and Uncertainties* (the Report), which was intended to help standards-setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This statement of position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

Scope

.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that issue such statements. While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. fn 1 If comparative financial statements are presented, the disclosure requirements apply only to the financial

statements for the most recent fiscal period presented.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations, proposed changes in accounting principles, fn 2 or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements

.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and, for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. fn * The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

Definitions

.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, fn 3 yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic. fn 4

Conclusions

.08 The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in

paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations

.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination—for example, assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as *predominately*, *about equally*, or *major and other*. fn 5

Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through 12, and 17b, and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies fn 6 that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

a. It is at least reasonably possible fn 7 that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible fn 8 that a change in the estimate will occur in the near term. fn 9 If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure of the risk-reduction techniques are encouraged but not required.

.16 This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

? If an estimate (including estimates that involve contingencies covered by FASB

Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.

? An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

? Inventory subject to rapid technological obsolescence

? Specialized equipment subject to technological obsolescence

? Valuation allowances for deferred tax assets based on future taxable income

? Capitalized motion picture film production costs

? Capitalized computer software costs

? Deferred policy acquisition costs of insurance enterprises

? Valuation allowances for commercial and real estate loans

? Environmental remediation-related obligations

? Litigation-related obligations

? Contingent liabilities for obligations of other entities

? Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits

? Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets

? Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 Paragraph 5 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, fn ? provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed. [fn 10] [Revised, April 1996, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if,

based on information known to management prior to issuance of the financial statements, *all* of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.

b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area **[fn 11]** *in which an entity conducts its operations.* The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

.23 Concentrations of financial instruments, and other concentrations not described in paragraph .22, are not addressed in this SOP. However, these other concentrations may be required to be disclosed pursuant to other authoritative pronouncements, such as FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, **fn ||** as amended by FASB Statement No. 126, Exemption From Certain Required Disclosures About Financial Instruments for Certain Nonpublic Entities. [Revised, June 2004, to reflect conforming changes necessary to reflect the issuance of FASB Statement No.133, as amended by FASB Statements No. 137, No. 138, and No. 149.]

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22*c*) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (paragraph .22*d*) that meet the criteria of paragraph .21, the following specific disclosures are required:

? For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.

? For operations located outside the entity's home country, disclosure should include

the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with FASB Statement No. 131. In accordance with paragraph .08 of this SOP, such information need not be repeated. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 131. fn #]

Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events. For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP's requirements if an appropriate judgment had been made that a near-term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

Effective Date

.26 This SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required.

Appendix A

Illustrative Disclosures

.27

A-1. The kinds of disclosures required by this SOP are illustrated below. Each illustrative disclosure is accompanied by a scenario in which the disclosure would likely be made or not made and by a discussion of how and why the illustrative disclosure complies with the requirements of this SOP or why no disclosure is required by this SOP.

Nature of Operations

Illustrative Disclosure A—Nature of Operations

A-2. *Scenario.* Conglomerate, Inc. is a United States-based multinational corporation. Conglomerate's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products. The principal markets for the company's automotive and aerospace products and technologies are European- and Far East-based industrial concerns. Textiles are sold primarily to U.S. clothing manufacturers, while nonprescription health-care products are sold to wholesale and retail distributors worldwide. The operations of the company in any one country are not significant in relation to the company's overall operations. The following illustrates disclosure of the nature of operations required by this SOP.

A-3. *Disclosure.* **Conglomerate, Inc. is a multinational manufacturer and engineering concern. The company's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products, all of which are about equal in size based on sales. The principal markets for the automotive and aerospace products and technologies are European- and Far East—based industrial concerns. Textiles are sold primarily to domestic clothing manufacturers, while nonprescription health-care products are sold primarily to wholesale and retail distributors worldwide.**

A-4. *Discussion.* This disclosure provides—

a. Information necessary for users not familiar with the operations of the company to identify and consider the broad risks and uncertainties associated with the businesses and markets in which the company operates and competes. From the disclosures provided, financial statement users having a general knowledge of business matters should be able to assess that the company's product lines are subject to different and varied risks. Those financial statement users familiar with the businesses recognize the general risks associated with each of these businesses and their related markets.

b. Information that facilitates the overall understanding of the financial information presented. This kind of disclosure could provide users with a basis for comparing an enterprise's financial information with that of competitors or with applicable industry statistics.

c. Insight into the location of the company's principal markets, although on a broad scale. Because the company's markets are so diverse, it likely would not be useful to enumerate the specific locations of the company's markets. For this reason, the manner in which the information is disclosed in the illustrative disclosure is sufficient to meet the broad objectives of paragraph .10 of this SOP.

Illustrative Disclosure B—Combined Disclosure: Nature of Operations and Customer Concentration

A-5. *Scenario.* Smith Corporation, formerly Smith Munitions Corporation, was founded in 1940. At that time, Smith's principal business was the design and manufacture of artillery ammunition and other explosives. In 1959, commensurate with the evolution of its principal business to the design, engineering, and manufacture of military aircraft for sale to the U.S. government, Smith changed its name to Smith Corporation. Smith has one factory, located in New York. The following illustrates disclosure of the nature of operations required by this SOP.

A-6. *Disclosure.* **Smith Corporation is engaged principally in the design, engineering, and manufacturing of military aircraft and related peripheral equipment for sale primarily to the U.S. government.**

A-7. *Discussion.* This disclosure provides—

a. Information needed by users who are not familiar with the operations of the enterprise to identify and consider the broad risks and uncertainties faced by all or most enterprises operating in a specific business or market, which in this case is the defense contracting business. From this disclosure, financial statement users having a general knowledge of business matters should know that the enterprise's business may be heavily affected by future changes in U.S. defense and foreign policies.

b. Information that aids in the overall understanding of the other financial information presented. Certain accounting procedures involving estimation may apply only to particular industries or may be relevant in comparing a business enterprise's financial reports with those of business enterprises in other industries.

c. Insight into the location of the company's principal product markets and information about its current vulnerability due to concentrations. In the illustration, users would be able to recognize and assess the company's dependency on sales to the U.S. government (assuming the loss of the government as a customer would result in a near-term severe impact to the company).

Use of Estimates in the Preparation of Financial Statements

Illustrative Disclosure—Pervasiveness of Estimates

A-8. *Scenario.* The following illustrates disclosure of the pervasiveness of estimates in the financial statements of all reporting entities.

A-9. *Disclosure.* **The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.**

A-10. *Discussion.* This disclosure is intended to inform users of the inherent uncertainties in measuring assets and liabilities and related revenues and expenses and contingent assets and liabilities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected. Such disclosure alerts users that uncertainties are present in the financial statements of all reporting entities.

Certain Significant Estimates

Note: Some of the following disclosures contain certain information that is already required to be disclosed under FASB Statement No. 5; in those cases, the FASB Statement No. 5 requirements are supplemented by an indication that it is at least reasonably possible that a change in an estimate will occur in the near term. Others may not be covered by FASB Statement No. 5.

Illustrative Disclosure A—Inventories

A-11. *Scenario.* XYZ Corporation manufactures high technology stereo equipment. In June 19X7, one of XYZ's competitors introduced a new model stereo system with the same features as XYZ's Model A. The competitor's version sells for significantly less than XYZ's suggested retail price for Model A. The introduction of this product resulted in a sharp decrease in the sales volume of Model A. At December 31, 19X7, XYZ has accumulated significant inventory quantities beyond its normal short-term needs of its Model A system. Inventory for Model A ($6 million) represents approximately 20 percent of XYZ's inventory at that date. The remaining 80 percent of XYZ's inventory consists of products experiencing only normal competitive pressures. XYZ has established provisions for obsolescence for this latter group of products in the normal course of business.

A-12. Management has developed a program to provide substantial dealer incentives on purchases of the Model A, which it expects will result in the sale of this inventory in the near term. Because of the existing high profit margin on its stereo systems, XYZ would continue to earn a marginal profit on sales of the Model A under the new program. It is also reasonably possible, however, that the program will not be wholly successful, and, accordingly, a material loss could ultimately result on the disposal of the inventory.

A-13. *Disclosure.* **At December 31, 19X7, some portion of $6 million of inventory of one of the company's products is in excess of XYZ's current requirements based on the recent level of sales. Management has developed a program to reduce this inventory to desired levels over the near term and believes no loss will be incurred on its disposition. No estimate can be made of a range of amounts of loss that are reasonably possible should the program not be successful.**

A-14. *Discussion.* This situation meets the criteria for disclosure under paragraph .13 of this SOP because circumstances that existed at the date of the financial statements, including the decreasing sales volume and excessive quantities of inventory of Model A, make it at least reasonably possible that management's plan to liquidate its excess inventory without a loss will be less than fully successful and that such an outcome would have a near-term material effect on the enterprise's financial statements.

A-15. In this illustration, XYZ discloses the existence of potentially excess quantities of inventory at the date of the financial statements and indicates that the uncertainty is expected to be resolved in the near term. The disclosure is intended to provide users with insight into management's assessment of recoverability of the cost of inventories existing at the date of the financial statements. Although disclosure of the $6 million carrying amount of the inventory of Model A is not required

because, based on the facts presented, $6 million does not constitute a reasonable estimate of loss on the disposal of the inventory or the maximum amount in an estimated range of loss, disclosure of this amount is not misleading and may provide useful information.

A-16. Discussion of XYZ's provision for obsolescence for the remaining 80 percent of its inventory is not required because it is not considered reasonably possible that additional material losses on this inventory will occur.

Illustrative Disclosure B—Discontinued Operations: Assets Held for Sale

A-17. *Scenario.* Axel Industries, a manufacturer of automotive parts and heavy trucks, currently has facilities in Michigan, Tennessee, and Ontario, Canada. Axel's automotive parts segment constitutes a component of the entity because the operations of and cash flows of the automotive parts segment can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. As a result of weak demand in the automobile industry, Axel's management decided during the current year to exit the automotive parts segment, which is located entirely at the company's Michigan facility, and commits to a plan to sell the automotive parts segment. Axel's automotive parts segment is classified as held for sale at that date and measured at the lower of its carrying amount or fair value less cost to sell. The operations and cash flows of the automotive parts segment will be eliminated from ongoing operations as a result of the sale transaction, and Axel will have no continuing involvement in the operations of the product group after it is sold. The scenario meets the requirements of FASB Statement No. 144. Therefore Axel will report the results of operations of the component, including any gain or loss, in discontinued operations. The following illustrates disclosure of significant estimates and would likely appear as part of the disclosure of the disposition of a component of an entity made pursuant to APB Opinion 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment to FASB Statement No. 13, and Technical Corrections*. [Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

A-18. *Disclosure.* **Included in discontinued operations was a write down associated with our automotive components parts business. The write down was based on management's best estimates of the fair value of the assets less costs to sell. The amount included in discontinued operations could be adjusted in the near term if experience differs from current estimates. [fn 12]** [Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

A-19. *Discussion.* Determining a provision for discontinued operations required the use of assumptions and estimates. In this case, the disclosure is required because circumstances that existed at the date of the financial statements indicated it was at least reasonably possible that estimates of the loss on the disposal of discontinued operations could differ in the near term from the current estimates used as a basis for recognizing the charge to income by an amount that would be material to the entity's financial statements. [Revised, July 2004, to reflect the conforming changes necessary due to the issuance of FASB Statements No. 144 and No. 145.]

Illustrative Disclosure C—Specialized Manufacturing Equipment

A-20. *Scenario.* Offshore Industries is a manufacturer of offshore drilling rigs and platforms. The company's manufacturing process requires significant specialized equipment, which it currently owns. As a result of a decline in the price of oil, the demand for its products and services has fallen dramatically in the past two years, resulting in a significant underutilization of its manufacturing capacity.

A-21. The company depreciates its investments in specialized equipment based on its original

estimate of the remaining useful lives of the equipment using the units-of-production method, since it believes that the exhaustion of usefulness of these specialized assets relates more to their use than to the passage of time. The company reevaluates these estimates in light of current conditions in accordance with generally accepted accounting principles. The company also monitors the policies of its major competitors and is aware that several have reported large write-downs of similar assets. Nevertheless, while the company believes that it is at least reasonably possible that its estimate that it will recover the carrying amount of those assets from future operations will change during the next year, it believes it is more likely that conditions in the industry will improve and that no write-down for impairment will be necessary.

A-22. *Disclosure.* **Offshore's policy is to depreciate specialized manufacturing equipment (with a net book value of $25 million at December 31, 19X7) over its remaining useful life using the units-of-production method and to evaluate the remaining life and recoverability of such equipment in light of current conditions. fn 13 [Given the excess capacity in the industry, fn 14 it is reasonably possible that the company's estimate that it will recover the carrying amount of this equipment from future operations will change in the near term.**

A-23. *Discussion.* In this illustration, the company acknowledges that the carrying amount of the specialized assets is subject to significant uncertainty based on current conditions. The uncertainty relates to the measurement of the specialized assets at the date of the financial statements, and the company's disclosure makes clear that it is at least reasonably possible that the carrying amount will change in the near term.

Illustrative Disclosure D—Capitalized Software Costs

A-24. *Scenario.* Software, Inc. develops and markets computer programs. In 20X3, it acquired a software company. A significant portion of the purchase price was allocated to (capitalized) Product A (present net book value of $5 million), the most significant and profitable software program currently being marketed by the acquired company. Only nominal amounts of other software costs have been capitalized. Software, Inc. expects Product A and its derivatives to be among its most significant products over the next several years. However, a competitor has recently released a new product designed to compete directly with Product A. Software, Inc. amortizes the capitalized software costs of Product A by the greater of (*a*) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (*b*) the straight-line method over the remaining estimated economic life of the product including the period being reported on, pursuant to FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.* The amount of the amortization computed for year 20X4 was equal to 20 percent of the beginning-of-the-year capitalized amount and was a significant component of cost of sales. [Revised, June 2004, to reflect conforming changes necessary due to the issuance of FASB Statement No. 141.]

A-25. The segment of the computer software industry in which Software, Inc. operates is characterized by sales of products occurring primarily on the basis of customers' perceptions of the relative technical merits of competing products. Those perceptions are greatly influenced by product reviews in technical journals and advertising, and they can change rapidly. Innovative products have been introduced in recent years that have reduced quickly and significantly the volume of sales of pre-existing products in the same market niche. While management of Software, Inc. believes its estimates of future gross revenues and the estimated economic life of Product A used in the determination of the amortization of capitalized software costs are reasonable, new products introduced by its competitors, such as the one discussed in paragraph A-24, could have a significant near-term negative effect on such estimates. As a result, the amount of periodic amortization could increase in the near term in amounts that could be material to the enterprise's financial statements.

A-26. *Disclosure.* **Software, Inc.'s policy is to amortize capitalized software costs by the**

greater of (a) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product including the period being reported on. fn 15 **It is reasonably possible that those estimates of anticipated future gross revenues, the remaining estimated economic life of the product, or both will be reduced significantly in the near term [due to competitive pressures].** fn 16 **As a result, the carrying amount of the capitalized software costs for Product A ($5 million) may be reduced materially in the near term.**

A-27. *Discussion.* In this illustration, the company acknowledges that the carrying amount of its capitalized software costs is subject to significant uncertainty. The uncertainty relates to estimates of future years' revenues and useful lives that are made at the date of the financial statements, and the company is aware that circumstances exist that could cause such estimates to change in the near term. The company's disclosure makes clear that it is at least reasonably possible that the carrying amount could be reduced in the near term.

Illustrative Disclosure E—Environmental Remediation Liability

A-28. *Scenario.* Ace Oil Company is a distributor of heating oil with four storage and distribution facilities located in Anystate. Federal, state, and local laws and regulations govern the operation of the company's facilities. The company has determined that, beginning in the coming year, a significant number of its storage tanks and a significant amount of its other equipment will need to be removed, replaced, or modified to satisfy regulations that go into effect in varying stages over the next seven years. In addition, the company has a present obligation to decontaminate the soil in the near term at its largest facility.

A-29. The company hired a consultant to evaluate the technological, regulatory, and legal factors involved. Based on the consultant's findings, the company estimated that total environmental expenditures over the next seven years related to the tanks and equipment will aggregate approximately $5 million. Of this amount, approximately $4.75 million represents capital expenditures, which are expected to be recoverable through operations. The existing tanks have a net book value of $500,000, and the equipment has a net book value of $475,000. The cost of soil decontamination is estimated to be at least $1 million, which is material to the company's operations, and may be as high as $3 million. Exposure to legal liability to third parties is considered remote.

A-30. The consultant has demonstrated substantial experience with similar sites, and the technical aspects of upgrading storage facilities and decontaminating soil appear to be fairly straightforward.

A-31. *Disclosure.* **The company will begin a project to decontaminate the soil at its Anytown, Anystate facility in the coming year. The company estimates the cost of decontamination to total at least $1 million and has accrued that amount as an operating expense in the current year.** fn 17 The ultimate cost [however, will depend on the extent of contamination found as the project progresses and fn 18] may be as much as $3 million. The company expects decontamination to be substantially completed within one year.

A-32. *Discussion.* This disclosure informs financial statement users of the existence of the soil contamination problem at the financial statement date and indicates that the liability is susceptible to change in the near term. This SOP does not require disclosure of the capital commitment because it is not a present obligation for which an estimate is reflected in the company's financial statements.

A-33. Although, in this case, the near-term nature of the possible change is indicated by a statement that the company expects decontamination to be substantially completed within one year, an expectation that decontamination will take more than one year to complete would not preclude the estimate from being susceptible to near-term change. In such cases, the disclosure could be worded to specifically refer to the near term.

Illustrative Disclosure F—Guarantee of Debt

A-34. *Scenario.* Shipping Company operates a shipping center in Local City. In 19X0, Shipping decided to raise money for modernization of facilities through a debt offering. In order for the offering to take place, Smokestack Company, a local manufacturer, agreed to guarantee the bonds if Shipping's revenues were insufficient to pay debt service. In May 19X4 (four years later when the bonds had an outstanding balance of $55 million), Shipping lost two of its major shipping customers, constituting 35 percent of its prior-year revenues, to a company in a neighboring port. At Smokestack's June 30, 19X4, year end, Shipping was directing substantial efforts toward finding new customers. It is reasonably possible, however, that Shipping will not replace the lost revenue in time to pay debt service installments at December 30, 19X4, and June 30, 19X5, totaling $6 million.

A-35. *Disclosure.* **In 19X0, Smokestack guaranteed the Series AA debt of Shipping Company, which operates a shipping center within Local City. Smokestack continues as guarantor of such debt totaling $55 million. In May 19X4, Shipping Company lost two of its major customers. Although Shipping Company is directing substantial efforts toward obtaining new customers, it is at least reasonably possible that Shipping Company will not replace lost revenues sufficient to make its December 19X4 and June 19X5 debt service payments totaling $6 million. If so, the company will become responsible for repayment of at least a portion of that amount and possibly additional amounts over the debt term. No amount has been reported in the company's financial statements pending the outcome of Shipping Company's efforts during the next fiscal year.**

A-36. *Discussion.* This example illustrates the potential near-term effect of a change in estimate of a contingent liability resulting from the guarantee of the debt of another entity. Shipping's loss of customers causes the potential for a near-term material change in that estimate within the next fiscal year. Although disclosure of Shipping's ongoing efforts to replace those customers is not required, this additional information may be presented.

Illustrative Disclosure G—Long-Term Construction Contract

A-37. *Scenario.* Rivet Construction Company is a nonpublic general contractor specializing in the construction of commercial buildings. Rivet has three long-term projects underway that are in various stages of completion. Rivet has a substantial history of making reasonably dependable estimates of the extent of progress towards completion, contract revenues, and contract costs, and it uses the percentage-of-completion method of accounting for all of its long-term contracts.

A-38. Shortly after December 31, 19X2, but before the 19X2 financial statements were issued, subsoil conditions were discovered at the site of Project A that will require Rivet to incur substantial additional, unbudgeted costs in completing the project. The nature of the subsoil problem is unusual in the region in which Rivet operates. The additional estimated costs are not considered to be a normal, recurring contract-accounting adjustment. Engineers have estimated the additional construction cost to be 10 to 40 percent of the original estimated construction cost, with 15 percent ($1.5 million) being their best estimate, and delays in construction are expected to add an additional 3 to 7 percent to the cost of construction, depending on the time involved, with 5 percent ($500,000) being the best estimate. Accordingly, Rivet has revised upward its estimate of costs to complete the project by $2 million. Project A, which was begun in 19X1 under a fixed-price contract, is still expected to be completed in the coming year (19X3), and it is still expected to be profitable.

A-39. The following is a summary of financial data at December 31, 19X2, for Project A.

	Before Discovery of Condition	*After Discovery of Condition*
Contract price	$15,000,000	$15,000,000
Estimated total cost	10,000,000	12,000,000

Estimated gross profit	5,000,000	3,000,000
Costs incurred to date	6,400,000	6,400,000
Percentage of completion	64%	53%

Rivet's other two projects are proceeding as planned.

A-40. *Disclosure.* **As a result of the discovery of unusual subsoil conditions at the site of Project A, estimated contract completion costs have been revised upward by $2 million. [Due to uncertainties inherent in the estimation process, fn 19] it is at least reasonably possible that completion costs for Project A will be further revised in the near-term [by up to an additional $2.7 million]. fn 20**

A-41. *Discussion.* In addition to any disclosures regarding the change in estimates that might be required by APB Opinion 20, fn 21 the disclosure requirements of this SOP focus on the effects of possible near-term changes in estimates. Disclosure is required under this SOP because it is at least reasonably possible that the estimated cost of completing Project A will change in the near term and that the change will be material to the financial statements.

A-42. Disclosure of the potential for changes in other estimates used in determining amounts reported for Rivet's long-term contracts is not required because, given Rivet's history of making similar estimates, it is not considered at least reasonably possible that they will change in the near term by amounts that would be material to the financial statements.

Illustrative Disclosure H—Realizability of a Deferred Tax Asset

A-43. *Scenario.* XYZ Corporation develops, manufactures, and markets limited-use vaccines. The company has a dominant share of the narrow market it serves. As of December 31, 19X4, the company has no temporary differences and has aggregate loss carryforwards of $12 million that originated in prior years and that expire in varying amounts between 19X5 and 19X7. As of December 31, 19X4, the company has a deferred tax asset of $4.8 million that represents the benefit of the remaining $12 million in loss carryforwards, and it has concluded at that date that a valuation allowance is unnecessary. The loss carryforwards arose during the company's development stage when it incurred high levels of research and development expenses prior to commencing sales. While the company has earned, on average, $6 million income before tax (taxable income before carryforwards) in each of the last five years, future profitability in this competitive industry depends on continually developing new products. The company has a number of promising new vaccines under development, but it is aware that other companies recently began testing vaccines that would compete with the vaccines being developed by the company as well as products that will compete with the vaccines that are currently generating the company's profits. Rapid introduction of competing products or failure of the company's development efforts could reduce estimates of future profitability in the near term, which could affect the company's ability to fully utilize its loss carryforward.

A-44. *Disclosure.* fn 22 **The company has recorded a deferred tax asset of $4.8 million reflecting the benefit of $12 million in loss carryforwards, which expire in varying amounts between 19X5 and 19X7. Realization is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.**

A-45. Discussion. This disclosure informs users that (*a*) realization of the deferred tax asset depends on achieving a certain minimum level of future taxable income within the next three years and (*b*) although management currently believes that achievement of the required future taxable income is

more likely than not, it is at least reasonably possible that this belief could change in the near term, resulting in establishment of a valuation allowance.

Illustrative Disclosure I—Litigation

A-46. *Scenario.* ABC Company is the defendant in litigation involving a major competitor claiming patent infringement. The suit claims damages of $200 million. Discovery has been completed, and ABC is engaged in settlement discussions with the plaintiff. ABC has made an offer of $5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of $35 million to settle the case, which offer was rejected by ABC. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, the company believes that it is probable the case will not come to trial. Accordingly, the company has determined that it is probable that it has some liability. The company's reasonable estimate of this liability is a range between $10 million and $35 million, with no amount within that range a better estimate than any other amount; accordingly, $10 million was accrued.

A-47. *Disclosure.* **On March 15, 19X1, the DEF Company filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to $25 million in excess of the amount accrued. fn 23**

A-48. *Discussion.* FASB Statement No. 5 requires accrual of a loss contingency and disclosure of the nature of the contingency, the exposure to loss in excess of the amount accrued, and, depending on the circumstances, the amount accrued. This SOP requires disclosure of an indication that it is at least reasonably possible that a change in the company's estimate of its probable liability could occur in the near term.

Current Vulnerability Due to Certain Concentrations

Note: The following are illustrations of the disclosures required by paragraph .21 of this SOP. Some of the concentrations described may fall into more than one of the categories of concentrations given in paragraph .22, a through d.

Illustrative Disclosure A—Supplier/Sources of Supply

A-49. *Scenario.* Hi-Tech Corp. is a manufacturer of electronic equipment in which integrated circuits are an important component. Substantially all of Hi-Tech's customers require that only those vendors that meet quality criteria be used as sources for integrated circuits. Hi-Tech currently buys all of its integrated circuits from one manufacturer in the Far East, and no long-term supply contract exists. There are only a limited number of manufacturers of these particular integrated circuits, and a change of supplier could significantly disrupt the business due to the time it would take to locate and qualify a new vendor.

A-50. *Disclosure.* **The company currently buys all of its integrated circuits, an important component of its products, from one supplier. Although there are a limited number of manufacturers of the particular integrated circuits, management believes that other suppliers could provide similar integrated circuits on comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which would affect operating results adversely.**

A-51. *Discussion.* Although other sources of supply of this particular kind of integrated circuit are currently available, the limited number of such sources and the time it takes to qualify new vendors makes Hi-Tech currently vulnerable to the risk of a near-term severe impact.

A-52. Disclosure is required because it is considered at least reasonably possible, based on information known to management prior to issuance of the financial statements, that the events that could cause the severe impact will occur.

Illustrative Disclosure B—Supplier/Sources of Supply

A-53. *Scenario.* Minnesota Company manufactures various products in which wheat is an important raw material. It currently buys 80 percent of its wheat from one supplier, but numerous alternate sources of supply are readily available on comparable terms.

A-54. *Disclosure.* (No disclosure is required.)

A-55. *Discussion.* The concentration exists at the date of the financial statements, and an inability to obtain wheat could result in a near-term severe impact. No disclosure is required, however, because numerous alternative suppliers are available and, therefore, it is not considered at least reasonably possible that events that could cause a near-term severe impact will occur.

Illustrative Disclosure C—Patent

A-56. *Scenario.* Felt Pharmaceutical Company is a national pharmaceutical manufacturer headquartered in Atlanta, Georgia. The company markets a wide range of pharmaceutical products. One of its better-known name-brand products, a significant source of profits and cash flow, is an antibiotic on which there is a patent that will expire in six months. Competitors are preparing to enter the market with generic alternatives when Felt's patent expires, and the concentration therefore has the potential for a severe impact.

A-57. *Disclosure.* **Felt Pharmaceutical Company is a national pharmaceutical manufacturer with sales throughout the United States. The patent on one of its major products expires next year. This product accounts for approximately one-third [or "a significant portion"] of the company's revenues and a higher percentage of its gross profit.**

A-58. *Discussion.* The disclosure focuses on the nature of the business and on Felt's current vulnerability due to a concentration of its patented products. Disclosure is required because the concentration exists at the date of the financial statements, because the effect on the company's cash flows and profitability of competitors entering the market when the patent expires could be a severe impact, and because it is considered at least reasonably possible that the events that could cause the severe impact will occur in the near term.

A-59. Because the risk is evident from the description of the concentration, no further explanation of the risk is necessary.

Illustrative Disclosure D—Source of Supply of Labor

A-60. *Scenario.* Team Company is a manufacturer of industrial hardware. The contract with the union representing Team's labor force is due to expire in the coming year. Over the past thirty years, Team has, in rare instances, been affected by work stoppages in the course of contract negotiations; they have always been of short duration, and none has had a significant effect on Team's financial statements. Although management expects that there will initially be some differences between its offer to the union and union demands, based on preliminary discussions with union leaders, management believes it is very unlikely that those differences will result in a protracted conflict.

A-61. *Disclosure.* **(No disclosure is required.)**

A-62. *Discussion.* Although the concentration of labor exists at the date of the financial statements and it could result in a severe impact in the near term due to the potential of a protracted work stoppage, no disclosure is required because it is not considered at least reasonably possible in the light of past experience and current conditions that a protracted work stoppage will take place.

Illustrative Disclosure E—Contributor

A-63. *Scenario.* Zebra Zoo, a not-for-profit organization, is supported by contributions from the public. In the current year, two contributors provided 35 percent of the organization's combined

revenues.

A-64. *Disclosure.* **Approximately 35 percent of the organization's combined revenues were provided by two contributors.**

A-65. *Discussion.* Disclosure is required because the two contributors provided a significant portion of the organization's revenues. As noted in paragraph .22, it is always considered reasonably possible that a customer, grantor, or contributor will be lost in the near term.

Illustrative Disclosure F—Geographic Area of Operations

A-66. *Scenario.* Offshore Productions, Inc. (Offshore), a Delaware corporation, designs and manufactures optical lenses, which it markets throughout the United States. Substantially all of its manufacturing operations are carried out in a single facility, which is located in Switzerland and which is owned by Offshore's subsidiary. Offshore does not carry insurance for risks of loss. Offshore's consolidated balance sheet includes $20 million representing the net assets of those operations.

A-67. *Disclosure.* **Included in the company's consolidated balance sheet at December 31, 19X4, are the net assets of the company's manufacturing operations, all of which are located in a single facility in Switzerland and which total approximately $20 million. [fn 24]**

A-68. *Discussion.* All of Offshore's specialized manufacturing capacity is concentrated in a single facility. As noted in paragraph .22, it is always considered at least reasonably possible that the use of a facility located outside of an entity's home country could be disrupted in the near term. Due to the specialized nature of the assets, it would not be possible to find replacement capacity quickly. Accordingly, loss of the facility could produce a near-term severe impact to Offshore. This disclosure informs financial statement users of that concentration of operations in a particular geographic area and informs them of the risks and uncertainties associated with the concentration. Because the concentration is one of operations located outside of Offshore's home country, the disclosure also sets forth the carrying amount of the net assets, as required by paragraph .24 of this SOP.

Appendix B

Background Information and Basis for Conclusions

.28

B-1. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). To support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40). Without additional disclosure in financial reports about significant risks and uncertainties, these objectives may not be fully met in today's environment.

B-2. Recognizing that a riskier business and economic climate equates to a riskier investment and lending climate, users increasingly are asking that financial statements include more information to help them assess the risks and uncertainties concerning a reporting entity's future cash flows and results of operations. These requests are underscored in calls for an "early warning system" expressed in the financial press and in congressional hearings.

B-3. No system of reporting can provide early warnings of all future detrimental events. Indeed, management may be unaware, and reasonably so, of some significant risks and uncertainties. And, clearly, financial statements should not be burdened in an attempt to describe every possible risk and

uncertainty facing the reporting entity.

B-4. But such limitations should not prevent users from receiving improved disclosures concerning significant risks and uncertainties. Their existence merely means that any new disclosure requirements must focus on what is important. New disclosure requirements should effectively separate the significant matters that warrant reporting from the host of lesser risks and uncertainties that do not. fn 25 AcSEC believes that the requirements in this SOP meet those objectives.

B-5. In reaching the conclusions in this SOP, AcSEC considered and evaluated users' reliance on financial information, sources of financial information, current accounting and disclosure requirements, current SEC requirements, and users' perceptions of the kinds of information that should be presented in financial statements.

Users' Reliance on Financial Information

B-6. Information in financial statements, shaped by generally accepted accounting principles (GAAP) and, for SEC registrants, by the additional regulatory requirements of the Commission, is considered important to users in making investment and lending decisions. Financial statements provide information about certain current conditions and trends that help users in predicting reporting entities' future cash flows and results of operations. The quality of users' predictions depends to a significant degree on their assessment of the risks and uncertainties inherent in entities' operations and of the information about those operations that financial reporting provides.

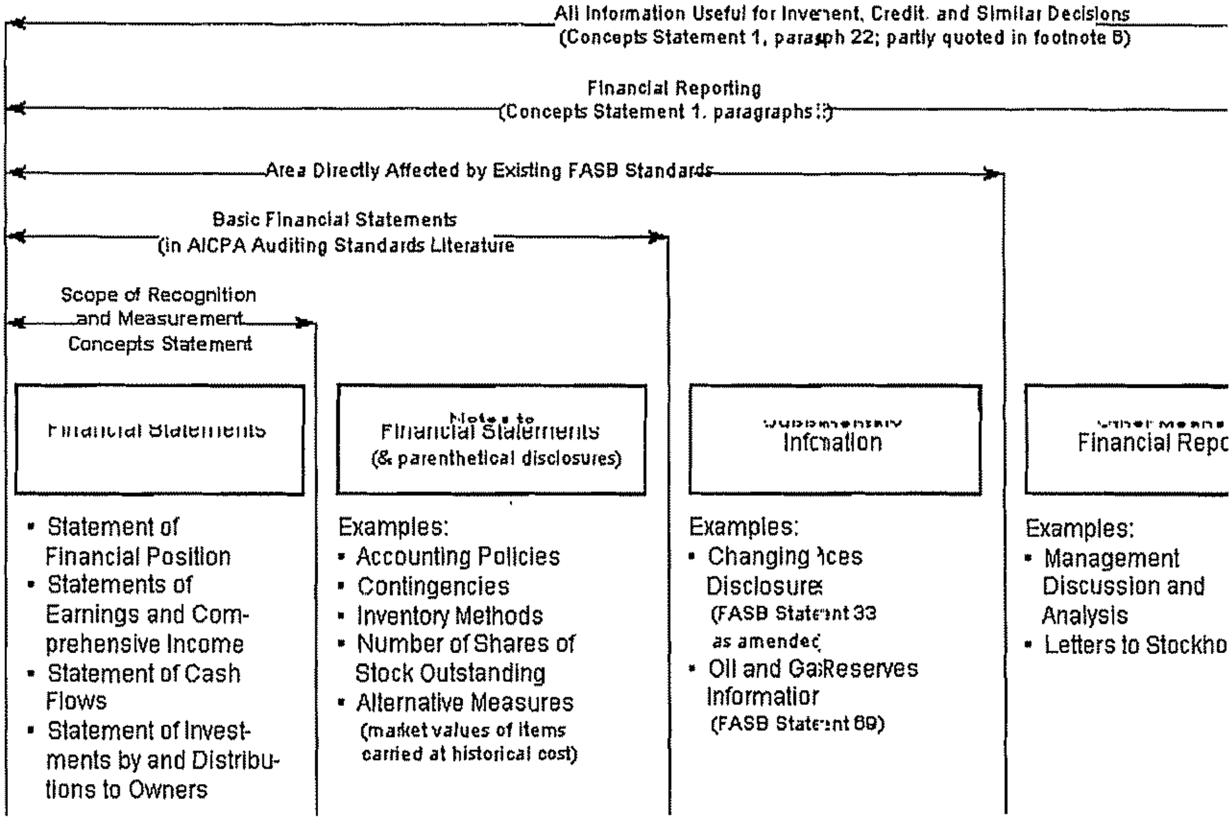
B-7. Financial reporting largely reflects the effects of past transactions and other events that have already affected a reporting entity. Such information can help users in assessing the future. But that does not mean the future can be predicted merely by extrapolating past trends or relationships. Indeed, volatility in the economic environment almost always means that simply extrapolating past trends and relationships will lead to inaccurate predictions. Users need to assess all currently available information to form their own expectations about the future and its relation to the past. Forming expectations—making predictions—is a vital part of the decision process. But it is a function of financial analysis, not of financial reporting. Furthermore, financial reporting is only one source of information required for making investment and credit decisions.

B-8. Reporting entities and those who have economic interests in them are affected by many factors that interact in complex ways. Those who use financial information for business and economic decisions need to combine information provided by financial reports with pertinent information from other sources, including additional information provided by issuers, financial analysts' reports, business and trade publications, and reports of macroeconomic and other local, national, and international events.

Sources of Financial Information

B-9. Financial reporting encompasses the financial statements and notes, required information supplementary to the financial statements, and other information, such as that included in Management's Discussion and Analysis (MD&A), which the SEC requires publicly held business enterprises to provide in their annual and quarterly reports. Additional sources of information include company releases, current information filings of publicly held business enterprises, investment advisory services, analysts' reports, the financial press, general economic statistics, and general news reports.

B-10. The major sources of financial information and their relationships for business and not-for-profit entities are illustrated in the following diagram, taken from FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.



Current Accounting Requirements

B-11. Disclosing information to help users assess major risks and uncertainties is consistent with the established objectives of financial reporting, and some such information is already presented in financial statements. Such information includes, for example, information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk, related party disclosures and information about receivables, leases, pensions, postretirement benefits, and commitments and contingencies. In addition, publicly held business enterprises are required to disclose in their financial statements segment information and information about foreign operations, export sales, and major customers, which, among other things, helps users to assess risks and uncertainties. This SOP, however, is intended to extend disclosures beyond those currently required and to help users discern those risks that are of particular importance.

Nature of Operations

B-12. Current GAAP (FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*) requires a public business enterprise to disclose the major types of products and services that generate revenues, that is, the nature of its businesses, as part of segment information in its financial statements, even if the business enterprise operates in only one industry. fn 26 Information presented includes a description of the types of goods or services provided, operating revenues, operating income or loss, net income or loss, net working capital, and total assets for each segment. But other reporting entities are not required to disclose such information. fn 27 Thus, financial statement users now sometimes cannot discern the nature of the operations of such other entities from information presented in their financial statements.

B-13. Information about the nature of operations is helpful because the various kinds of

businesses in which reporting entities operate have diverse degrees and kinds of risks. Certain of these risks are inherent to the business in which an entity is engaged. Simply by knowing the nature of an entity's business and the principal markets for its products or services, a financial statement user is alerted, indirectly, about the risks common to that business.

B-14. Some have expressed concerns about whether this SOP conflicts with FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*. AcSEC believes that, while the information that this SOP requires to be disclosed concerning the nature of a reporting entity's operations overlaps in certain respects the information public business enterprises are required to report under FASB Statement No. 14, it is significantly different in other respects. Accordingly, AcSEC does not believe this SOP conflicts with Statement No. 21.

B-15. Further, AcSEC notes that, for public business enterprises that already disclose information about the nature of their operations pursuant to FASB Statement No. 14, this SOP requires disclosure of additional information about the nature of their operations.

B-16. The disclosure required by paragraph .10 of this SOP focuses on the entity's principal markets, including their locations. Current segment information for business enterprises, in contrast, focuses on the nature of the segments' operations and their identifiable assets and the geographic location of assets outside the enterprise's home location. Disclosure of the locations of a business or not-for-profit entity's principal markets provides information useful in assessing risks and uncertainties related to the environments in which the entity operates. The risks and the uncertainties associated with selling products and services in various regions in the United States may differ significantly. And they do differ significantly from the risks and the uncertainties in selling products and services outside the United States. Knowing those environments in which an entity sells its products or provides services helps users of financial reports to assess certain risks based on day-to-day national and world events.

B-17. The following table compares and contrasts the information required of public companies by FASB Statement No. 14 with paragraph .10.

Disclosure	*FASB Statement No. 14*	*Paragraph .10*
Description of the types of products or services sold	X	X
Revenue, profitability, identifiable assets, and other related disclosures for each reportable segment	X	fn **
Revenue, profitability, identifiable assets for foreign operations, by geographic area	X	fn ??
Export sales by domestic operations, by geographic area	X	
Significant sales to single customer, foreign government, or domestic governmental agency	X	fn ??
Identification of principal markets		X
Description of location of principal markets		X

B-18. AcSEC considered whether disclosure of an entity's principal operating locations would be informative to financial statement users and should, therefore, be included in paragraph .10. AcSEC concluded that, although in certain circumstances such information would be relevant, generally it would not be. In addition, disclosure of an entity's principal operating locations would be required under paragraph .21 (current vulnerability due to certain concentrations) in circumstances where operating in

that particular environment created substantive near-term risk to the entity. Knowing, however, that a manufacturing plant is located in Dallas, Texas, for example, was not considered particularly relevant information. In contrast, knowing where a residential housing construction contractor's principal market is located was considered to be highly relevant. As a result, disclosure of the location of principal markets was chosen by AcSEC for inclusion in paragraph .10, while disclosure of the location of principal operating units was considered unnecessary.

Use of Estimates in the Preparation of Financial Statements

B-19. Auditors are required under generally accepted auditing standards (GAAS) fn 28 to acknowledge in their standard reports the use of estimates in the preparation of financial statements. AcSEC has concluded, however, that an explanation that the preparation of financial information requires the use of estimates and assumptions should be included in the financial statements by the reporting entity to inform users of the nature and limitations of those financial statements. AcSEC acknowledges that the disclosure would usually be standardized. AcSEC nevertheless believes it would help users make sounder use of financial statements.

B-20. There is a need to communicate explicitly to users of financial reports that the inescapable use of estimates in the preparation of financial information, including the estimation of fair and, in some cases, market values for assets carried at such bases, results in the presentation of a number of approximate rather than exact amounts. If users understand better the inherent limitations on precision in financial statements, they will be better able to make decisions.

B-21. Estimates inherent in the current financial reporting process inevitably involve assumptions about future events. For example, accruing income for the current period under a long-term contract requires an estimate of the total profit to be earned on the contract. For another example, carrying inventories at the lower of cost or market is based on an assumption that there will be sufficient demand for that product in the future to be able to sell the quantity on hand without incurring losses on the sales or, if market is used, that it can be estimated. Making reliable estimates for such matters is often difficult even in periods of economic stability; it is more so in periods of economic volatility. Although many users of financial reports are aware of that aspect of financial reporting, others often assume an unwarranted degree of reliability in financial statements. The disclosure required by this SOP should help dispel any such erroneous assumptions.

B-22. A number of publicly held business enterprises now include management reports in annual reports to stockholders. Many such reports and letters state that estimates and assumptions are required to prepare financial statements in conformity with GAAP. AcSEC acknowledges that development, but it believes the disclosure should be mandated and included in the notes to financial statements.

Certain Significant Estimates

B-23. FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:

> If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.*6 The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added.] [FASB Statement No. 5, paragraph 10]

Footnote 6 to Statement No. 5 states:

> For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably

> estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability had been incurred at the date of the financial statements. [Emphasis in original.]

FASB Statement No. 5 defines loss contingencies as:

> an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. [paragraph 1]

The recognition and disclosure requirements of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss.* This SOP does not change the requirements of FASB Statement No. 5 or FASB Interpretation No. 14; the requirements of this SOP supplement those requirements. For example, if a loss contingency meets the criteria for disclosure under both Statement No. 5 and paragraph .13 of this SOP, this SOP requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.

B-24. This SOP also requires disclosure of matters that may not be deemed to be contingencies requiring disclosure under current GAAP. FASB Statement No. 5 distinguishes loss contingencies from other uncertainties inherent in making accounting estimates, as follows:

> Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition [of a contingency] in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred. [paragraph 2]

FASB Statement No. 5 acknowledges, however, that the distinction between uncertainties inherent in making accounting estimates and uncertainties that give rise to a contingency is not always clear:

> A question has been raised whether uncollectibility of receivables and product warranties constitute contingencies within the scope of this Statement. The Board recognizes that uncertainties associated with uncollectibility of some receivables and some product warranties are likely to be, in part, inherent in making accounting estimates (described in paragraph 2) as well as, in part, the type of uncertainties that give rise to a contingency (described in paragraph 1). The Board believes that no useful purpose would be served by attempting to distinguish between those two types of uncertainties for purposes of establishing conditions for accrual of uncollectible receivables and product warranties. Consequently, those matters are deemed to be contingencies within the definition of paragraph 1 and should be accounted for pursuant to the provisions of this Statement. [paragraph 58]

B-25. AcSEC believes that requiring disclosure of certain estimates not deemed to be covered by

current GAAP, for example, some amounts reported for long-term contracts, would enhance the usefulness of financial statements in assessing risks and uncertainties.

B-26. Among the matters specifically excluded from the scope of FASB Statement No. 5 is the write-down of operating assets. Paragraph 31 of Statement No. 5 states:

> In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected to be recoverable through future use of that asset even though there has been no physical loss or damage of the asset or threat of such loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.

The requirements of paragraph .13 of this SOP are applicable to long-lived assets whose value may become impaired in the near term.

B-27. On November 29, 1993, the FASB issued an exposure draft of a Proposed Statement of Financial Accounting Standards, *Accounting for the Impairment of Long-Lived Assets*. That exposure draft is expected to result ultimately in the promulgation of authoritative guidance on recognition, measurement, and disclosure requirements for long-lived assets whose carrying amounts may not be recoverable. Paragraphs 102 and 103 of the exposure draft state:

> In 1985, the AICPA established a task force to consider the need for improved disclosures about risks and uncertainties that affect companies and the manner in which they do business. In July 1987, the task force published *Report of the Task Force on Risks and Uncertainties*, which concluded that companies should be making early warning disclosures as part of their financial statements. In March 1993, AcSEC issued an exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*. That proposed SOP would require entities to include in their financial statements disclosures about (*a*) the nature of their operations, (*b*) the use of estimates in the preparation of their financial statements, (*c*) certain significant estimates, (*d*) current vulnerability due to concentrations, and (*e*) financial flexibility.

Board members observed that for some impairments early warning disclosures would be useful. However, they were in general agreement, based on comment letters and testimony, that it would not be possible to adequately describe those situations and develop adequate disclosure requirements. Some Board members also believed that the proposed SOP is a much broader disclosure requirement that could have implications in several other Board projects. Board members therefore concluded not to require early warning disclosures in this Statement.

AcSEC notes that, while the exposure draft would not require early warning disclosures concerning impairment of long-lived assets, it acknowledges the usefulness of such disclosures and recognizes that the disclosure requirement of this SOP is a much broader requirement than the FASB considered.

Current Vulnerability Due to Certain Concentrations

B-28. Current GAAP requires disclosure of certain concentrations (for example, credit concentrations under FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and information about major customers under FASB Statement No. 14 for public enterprises) but does not specifically address disclosures of concentrations on a comprehensive basis. This SOP addresses known concentrations more comprehensively but stops short of requiring disclosure of all concentrations.

B-29. Some believe that disclosure of economic dependency is required under current literature.

A requirement to disclose economic dependency was included in SAS No. 6, *Related Party Transactions*. But, partly in response to the issuance of FASB Statement No. 57, *Related Party Transactions*, the AICPA superseded SAS No. 6 in August 1983 with the issuance of SAS No. 43, *Omnibus Statement on Auditing Standards—1983*, which, among other things, "remov[ed] guidance on accounting considerations and disclosure standards . . . provided in FASB Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*." Statement No. 57 states, in turn, that it "does not address the issues pertaining to economic dependency."

B-30. The FASB observed in Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, which was issued in April 1978 and which eliminated the requirement for nonpublic enterprises to disclose information about major customers, that FASB Statement No. 21 "does not affect the disclosure of information about economic dependency when such disclosure may be necessary for a fair presentation." That observation, however, refers to the now-superseded SAS No. 6.

B-31. AcSEC believes that disclosure in the notes to financial statements about current vulnerability due to concentrations of customers, grantors, and contributors is necessary for a fair presentation when the criteria in paragraph .21 of this SOP are met. Assessing the likelihood of loss of relationships with these parties would often present difficulties, however. Accordingly, for purposes of this SOP, it is always considered at least reasonably possible that any of these relationships will be lost in the near term. Similarly, because of the difficulty in assessing the political and economic risks associated with operations located outside an entity's home country, for purposes of this SOP, it is always considered at least reasonably possible that those operations might be disrupted in the near term. This SOP does not, however, prohibit entities from also stating in disclosures of concentrations related to customers, grantors, or contributors or operations located outside the entity's home country that the entity does not expect that the business relationship will be lost or does not expect that the foreign operations will be disrupted if such is the case.

B-32. AcSEC considered whether it would be useful to establish quantitative criteria for disclosure of concentrations, either in place of or in addition to the qualitative criteria provided. AcSEC believes that a quantitative approach might not provide meaningful information about an enterprise (for example, a critical supplier is not necessarily a major supplier). Any potential simplification in implementing the disclosure requirements that might result from a quantitative approach would be outweighed by deterioration in the quality of information provided.

Current SEC Requirements

B-33. The SEC requirement for information to be included in MD&A expands the information that financial reporting otherwise provides to include certain specific kinds of information related to liquidity, capital resources, and results of operations. It further expands the information to include management analysis of trends and other factors. Thus, management's subjective analysis is a significant part of the information users obtain from financial reporting of publicly held business enterprises as the data for their decisions.

B-34. The FASB's Concepts Statements present the view that such analysis is helpful to users. For example, in Concepts Statement No. 1, the FASB observes that financial reporting should include explanations and interpretations and cites as an example management's explanation of the information as a significant aid to users.

B-35. Under SEC requirements relating to MD&A, publicly held business enterprises are required to describe, among other things, "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations" (Regulation S-K, Item 303(a)(3)(ii)). SEC Financial Reporting Release (FRR) No. 36 clarifies that disclosure is required unless management determines that the trend or uncertainty is not reasonably likely to occur or that a material effect on the registrant's

financial condition or results of operations is not reasonably likely to occur. Publicly held business enterprises are encouraged but not required to include forward-looking information relevant to a full understanding of their past and anticipated operations.

B-36. The disclosure of current vulnerability due to certain concentrations required by paragraph .21 of this SOP differs from the MD&A requirement in two important respects. First, the MD&A rules apply broadly to "any known trends or uncertainties," whereas paragraph .21 applies only to certain known concentrations. Second, this SOP requires disclosure only if the effect would cause a severe impact in the near term—a higher threshold than "material" used for MD&A purposes. AcSEC believes a higher threshold is needed for these disclosures to avoid required disclosure of lengthy lists of risks related to concentrations that are reasonably possible in today's environment and at the same time still meet the objective of providing an early warning of the potential for a disruptive set of events occurring in the near term.

B-37. The SEC also requires registrants, "where appropriate," to include in prospectuses offering securities to the public "a discussion of the principal factors that make the offering speculative or one of high risk." Among the factors cited are "the financial position of the registrant" and "the nature of the business in which the registrant is engaged or proposes to engage" (Regulation S-K, Item 503(c)).

B-38. This information required by the SEC is not now required for entities not subject to SEC regulation. However, expanding the scope of financial statements to include some of such information is compatible with the objectives of financial reporting. This SOP requires disclosure in the notes to financial statements of some of the information now reported in MD&A or as risk factors but might also require disclosure of certain information not currently required in either place.

Comments Received on Exposure Draft

B-39. An exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*, was issued for public comment on March 31, 1993, and distributed to approximately 20,000 interested parties to encourage comment by those who would be affected by the proposal. Over 300 comment letters were received in response to the exposure draft. Substantially all of the responses expressed reservations regarding the exposure draft's required disclosures of certain significant estimates, current vulnerability due to concentrations, and financial flexibility, while relatively few respondents expressed concerns regarding the disclosure of the nature of the reporting entity's operations or the use of estimates in the preparation of financial statements.

B-40. The most significant and pervasive concerns can be summarized in three areas:

a. The cost of determining the necessity of the disclosures will exceed the benefit received from providing them, particularly for small, privately owned entities, and particularly with respect to the requirements for disclosure of financial flexibility.

b. Requiring disclosures based on information "of which management is reasonably expected to have knowledge" is too subjective and unnecessarily expands costs and liability as well as the "expectation gap."

c. "Reasonably possible" is too low a threshold and is an insufficiently objective criterion for disclosure of a broad range of possible future events.

B-41. AcSEC considered the comments received on the exposure draft and took the following actions in response to them.

a. The requirement for disclosure of financial flexibility has been eliminated from this SOP. Financial flexibility was the exposure draft's most controversial requirement, with deep concerns expressed about the cost of compliance. Other concerns were expressed regarding the overlap between the exposure draft's requirements and the requirements of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and the ability of the

exposure draft's criteria to highlight meaningful information and to differentiate among entities that have different risks.

AcSEC does, however, continue to consider financial flexibility disclosures to be relevant early warnings for financial statement users. AcSEC also believes that disclosure requirements such as those included in SAS No. 59 should be included in accounting rather than auditing standards. Therefore, AcSEC and the AICPA's Auditing Standards Board are considering forming an interdivisional task force to develop accounting standards to provide the appropriate early warnings of possible financial difficulties and to replace disclosure requirements currently included only in auditing standards.

b. This SOP requires disclosure of certain defined concentrations known to management rather than a wider range of concentrations based on information of which management "is reasonably expected to have knowledge." Further, because of the continuing activity of the FASB in establishing disclosure requirements related to financial instruments, none of the defined concentrations relate specifically to financial instruments. The disclosures are to be made when (*a*) the concentrations are known to exist at the date of the financial statements, (*b*) they make the enterprise vulnerable to the risk of a near-term severe impact, and (*c*) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

AcSEC considered eliminating the reasonably possible and severe-impact disclosure criteria, but decided that retention of these criteria should promote disclosures that are more significant and useful than standardized listings that might otherwise result.

c. The requirements to disclose certain significant estimates have been clarified to make them more consistent with the requirements of FASB Statement No. 5. This SOP requires discussion of estimates when, based on known information available prior to the issuance of the financial statements, it is reasonably possible that the estimate will change in the near term and the effect of the change will be material. AcSEC responded to concerns regarding the predictive nature of this disclosure requirement by stipulating that it is the estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements that must be disclosed and that the evaluation should be based on known information available prior to issuance of the financial statements.

AcSEC also revised the disclosure requirements included in the exposure draft applicable to estimates not involving loss contingencies covered by FASB Statement No. 5. With respect to such estimates, this SOP does not require the disclosure of the possible loss or range of loss or the statement that such an estimate cannot be made.

Placement of Disclosures

B-42. A significant number of commentators recommended that, because of the subjectivity associated with some of the disclosures required by this SOP, they should be presented outside the basic financial statements, either as supplemental information or in MD&A.

B-43. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, distinguishes between information that should be part of the basic financial statements and that which should be provided as supplementary information. Paragraph 7 of Concepts Statement No. 5 emphasizes that information disclosed as part of the basic financial statements amplifies or explains information recognized in financial statements and is essential to understanding that information. FASB Statement No. 107, however, points out in paragraph 75 a need for disclosure about "many important items . . . not recognized as assets and liabilities in financial statements, and many transactions and other events . . . not recognized when they occur but only later when uncertainty about them is reduced sufficiently so that their effects are clear."

B-44. The disclosures required by this SOP build on disclosures already included in the basic

financial statements and, like them, serve one of the major purposes of disclosure summarized in Appendix D of FASB Statement No. 105, that is, to help in assessing risks and potentials. AcSEC also believes that the changes made in response to the comments received on the exposure draft have significantly reduced the subjectivity of the disclosures. Accordingly, AcSEC concluded that all of the disclosures now required by this SOP should be included in the basic financial statements.

Scope

B-45. The exposure draft of this SOP would have applied to state and local governmental units. However, concern was expressed that inclusion of such entities unduly complicated the SOP. Further, resolving financial reporting issues unique to state and local governments that were brought up by commentators on the exposure draft—especially in the light of the other substantive changes made to the exposure draft—would have unduly delayed the issuance of this SOP. AcSEC believes the understandability of this SOP is improved by not including state and local governmental units in its scope. fn 29

B-46. Many commentators on the exposure draft recommended that other reporting entities, especially smaller nonpublic reporting entities, be exempted from this SOP's disclosure requirements. AcSEC considered those recommendations and concluded that the disclosures required by this SOP are no less relevant for such entities and that the changes made to the exposure draft sufficiently mitigate the concerns expressed by commentators.

B-47. Some commentators requested that AcSEC clarify the applicability of the SOP's requirements to financial statements prepared using an Other Comprehensive Basis of Accounting (OCBOA). AcSEC concluded that the applicability of disclosures required by GAAP to OCBOA financial statements is a pervasive issue that is beyond the scope of this SOP.

Field Tests

B-48. The March 31, 1993 exposure draft *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility* was subjected to limited field testing in which the exposure draft was applied to small and medium-size businesses, a not-for-profit organization, and case studies. The issues highlighted by the results of those tests were similar to the issues raised in the comment letters on the exposure draft. The results of the field tests were considered by AcSEC in its deliberations of this SOP.

Cost/Benefit

B-49. AcSEC believes the disclosures required by this SOP will improve financial reporting by providing, in a number of situations, information that will assist financial statement users in assessing certain risks and uncertainties inherent in financial reporting. AcSEC also believes the changes made to the exposure draft, which are discussed in paragraph B-41, are reasonably responsive to concerns expressed by commentators about the cost of determining the need for and making those disclosures.

B-50. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states in paragraph 142 that:

> The costs and benefits of a standard are both direct and indirect, immediate and deferred. They may be affected by a change in circumstances not foreseen when the standard was promulgated. There are wide variations in the estimates that different people make about the dollar values involved and the rate of discount to be used in reducing them to a present value . . . [It has been observed that] "the merits of any Standard, or of the Standards as a whole, can be decided finally only by judgments that are largely subjective. They cannot be decided by scientific test."

B-51. While a reliable evaluation of costs versus benefits is not possible, AcSEC believes that the benefits of the disclosures required by this SOP will outweigh their costs.

AICPA Special Committee on Financial Reporting

B-52. In the Spring of 1991, the AICPA's Board of Directors formed a Special Committee on Financial Reporting to address increasing concerns about the relevance and usefulness of financial reporting. The committee's charge is to recommend to standards setters and regulators (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information. The focus of the Special Committee's work is on the information needs of investors and creditors, and its recommendations will be responsive to those needs.

B-53. In its November 1993 report on the information needs of today's users of financial reporting, *The Information Needs of Investors and Creditors*, the Special Committee stated:

> Users want operating opportunities and risks identified based on the company and its segments rather than on an industry-wide basis. They also want information about opportunities and risks resulting from concentrations in assets, customers and suppliers.

B-54. AcSEC considered the Special Committee's preliminary findings in developing this SOP, and AcSEC may reconsider the guidance in this SOP in the light of the Special Committee's recommendations, if and when the conclusions are implemented by standards-setting bodies.

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